DOCKET FILE COPY ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the	)	
Cable Television Consumer Protection	)	MM Docket No. 92-266
and Competition Act of 1992	)	
Rate Regulation	)	
	)	
Leased Commercial Access	)	CS Docket No. 96-60

COMMENTS OF
<u>THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.</u>

Daniel L. Brenner
Diane B. Burstein
1724 Massachusetts Avenue, N.W.
Washington, D.C. 20036

Counsel for the National Cable
Television Association, Inc.

May 15, 1996

TABLE OF CONTENTS

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections o the	)	
Cable Television Consumer Protection	)	MM Docket No. 92-266
and Competition Act of 1992	)	
Rate Regulation	)	
	)	
Leased Commercial Access	)	CS Docket No. 96-60

COMMENTS OF
THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.

The National Cable Television Association, Inc. ("NCTA"), by its attorneys, hereby submits its comments in the above-captioned proceeding. NCTA is the principal trade association of the cable television industry in the United States. Its members include cable television operators serving over 80 percent of the nation's cable television subscribers and over 100 cable program networks that now command 50 percent of the viewership in cable households.

INTRODUCTION AND SUMMARY

In this Further Notice of Proposed Rulemaking ("Further Notice"), the Commission proposes to radically alter its rules for determining the rates that cable operators may charge for commercial leased access by unaffiliated programmers. Under the existing formula, operators may establish a rate for commercial access based on the "highest implicit fee" ("HIF") paid by any unaffiliated programmer for use of a cable channel. Under the Further Notice's proposed formula, that charge would no longer be based on implicit costs for use of a channel. Instead, the proposed cost methodology allows a rate based only on a limited range of costs until lessees occupy the full channel capacity required by the statute.

Contrary to its professed intention, the Commission's proposed cost methodology provides a massive subsidy for leased access programmers that will adversely affect cable program networks in particular. The proposed methodology:

- will result in rates for lessees that reflect little or none of the real costs or the value of cable carriage, or of being placed in packages of attractive cable programming services. This contravenes Congress' intent that leased access should be provided at commercial, not subsidized, rates.

- will result in leased access users displacing popular program networks, and will prevent operators from adding new popular networks that their subscribers want as channel capacity becomes available.

- will cause significant harm to consumers, who will likely lose program services that they desire and in their place find less attractive offerings.

- And, contrary to the dictates of Section 612 of the Cable Act, will demonstrably harm the "operation, financial condition, [and] market development" of cable systems.

The Further Notice also errs in suggesting that lessees have a right to be placed in highly penetrated tiers of program offerings. Nothing in the Act requires such a rule. While operators may voluntarily choose through negotiations with the lessee to place its channel in a tier, the ability to be placed in prime cable real estate must not be mandated by the Commission.

The victims of a radical restructuring of the rules of leased access will be popular cable program services and their viewers. The Commission can and should avoid this unwarranted outcome, so contrary to the public's interest in cable programming, by adopting fair rate rules that fully reflect the value of being carried on a cable system and by protecting viewers against significant disruptions to their channel line-ups. A modification of the existing rules which accomplishes this goal is detailed below.

ARGUMENT

I. THE HISTORY OF LEASED ACCESS REQUIREMENTS

The Further Notice explains that "cable operators and leased access programmers agree that relatively little leased access capacity is being used by unaffiliated programmers."[1] But the proposal to completely undo the existing HIF formula reflects an underlying Commission concern that this lack of leasing may be due to the rates that its rules currently allow cable operators to charge lessees -- rather than other factors. The Further Notice tentatively concludes that the existing formula "is likely to overcompensate cable operators and does not sufficiently promote the goals underlying the leased access provisions."[2] A review of the history of leased access, however, demonstrates that (1) the goals underlying the leased access provision have largely been fulfilled, notwithstanding the absence of a robust market for the leasing of full-time channels on cable systems by unaffiliated programmers, and (2) the Commission has no record before it to suggest that the current leased access rates, adopted in 1993, are the source of widespread inability of unaffiliated programmers to gain access to cable systems.

Congress adopted the commercial leased access requirement in 1984 in order to "assure that the widest possible diversity of information sources are made available to the public from cable systems in a manner consistent with growth and development of cable systems."[3]

---

1 Further NPRM at ¶ 6.

2 Id. at ¶ 7.

3 P.L. 98-549, Section 612 (a).

Congress was concerned that while operators may have had an incentive to provide diverse programming, they may not have had a similar incentive to provide cable programming from diverse sources -- that is, that they would unfairly deny access to cable programming with which they disagreed politically or which competed with their affiliated program offerings.[4] As a consequence, Congress reasoned that unaffiliated programmers would be unable to reach audiences since "cable [in 1984 was] unique in its ability to provide a single outlet for diverse sources of programming to the community."[5]

Some historical perspective is necessary to understand this concern. At the time Congress adopted this provision, cable operators typically provided an average of 23 activated channels of service.[6] Only 48 national program networks were in existence,[7] and of those networks, more than half were vertically integrated with cable operators.

Cable systems today, however, bear little resemblance to systems in 1984. While Congress was concerned that unaffiliated networks might be stymied in 1984, such a concern has not been borne out over the last dozen years. There are nearly three times as many national program networks today than there were in 1984 (137 versus 48).[8] This programming is both diverse in nature and diverse in sources of ownership. Approximately 60 of the national

---

4 H. Rep. No. 98-934, 98th Cong., 2d Sess. 48 (1984) (hereinafter "1984 House Report").

5 S. Rep. No. 98-67, 98th Cong., 1st Sess. 22 (1984) (hereinafter "1984 Senate Report").

6 Cable Television Service (Competition and Rate Deregulation Policies), 67 R.R. 2d 1771, 1832 (1990) at Appendix F (FCC data on channels available in average system).

7 NCTA, Cable Television Developments (Spring 1996) at 6.

8 Id.

program networks have no cable ownership interest.[9] And of the top 25 cable networks (measured in terms of subscribership), nearly one-third are unaffiliated with any cable system owners.[10]

And to the extent there remains a concern with cable operators disfavoring programming in which they have no ownership interest, Congress in 1992 enacted several provisions intended to ensure that that would not be the case. These include channel occupancy rules that limit the number of cable slots that can be occupied by programmers in which an operator has an attributable interest,[11] rules ensuring that operators cannot demand a financial interest in return for carriage[12] and cannot unfairly discriminate against unaffiliated programmers,[13] and must carry rules ensuring access by broadcast stations to cable systems.[14]

Moreover, while leased access rules were in part premised in the notion that unaffiliated programmers had no outlet other than cable, cable operators are no longer the only distribution outlet in a community. Programmers that are unable to gain carriage on cable systems have numerous alternative avenues to reach an audience -- including nationwide distribution on

---

9 Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming, Second Annual Report, CS Docket No. 95-61 (rel. Dec. 11, 1995) at Table 2 (over 60 existing national programming services have no cable ownership interest).

10 Moreover, Viacom owns 4 of the top 25 networks. It is seeking to transfer its cable system interests. Once that occurs, 12 of the top 25 networks will have no affiliation with cable system operators.

11 47 C.F.R. § 76.504.

12 Id., § 76.1301 (a).

13 Id., § 76.1301 (c).

14 Id., § 76.56.

DBS,[15] distribution on MMDS, and a variety of other multichannel video programming options.[16]

Given this dramatic growth in the programming and distribution market place, it is clear that Congress' goals in adopting leased access in 1984 have largely been realized. Therefore, the absence of widespread leasing by unaffiliated programmers should not be interpreted by the Commission as evidence that access to unaffiliated programming has been denied. The fact that unaffiliated program networks have gained access to cable systems under mutually agreeable terms and conditions, rather than through leased access, should be a welcome development, rather than a cause for concern.

Moreover, a review of the complaints filed with the Commission regarding leased access demonstrates few complaints regarding pricing. Instead, many appear to be complaints about a particular system's administration of its leased access channel process -- such as failure to make rate information available.[17]

Those few complaints regarding price are largely directed to systems serving large markets.[18] It should not be surprising to find, however, that lessees who are buying 24 hour a

---

[15] The 1992 Cable Act forbids exclusive cable franchising. And the 1996 Telecommunications Act permits telephone companies to be franchised cable operators. Ameritech and U S West have both decided to over build.

[16] See Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, CS Docket No. 95-61 (rel. Dec. 11, 1995) (recognizing growing competition to cable).

[17] See, e.g., R.K. Production Co. v. Adelphia, CSR 4491-L (rel. Jan 19, 1996); R.K. Production Co. v. The Armstrong Group of Companies, CSR 4492-L (rel. Jan. 26, 1996).

[18] For example, complaints about price were lodged against a cable operator in six major markets. Denver Area Educational Telecommunications Consortium, Inc. v. Tele-Communications, Inc., CSR 4595-L (rel. Oct. 31, 1995). The lessee sought full-time carriage on systems serving approximately 600,000 subscribers.

day, 7 day a week access to hundreds of thousands of cable subscribers would pay a rate that reflects that broad distribution - and which, for certain lessees, might be too expensive. But leasing the equivalent of a full-time broadcast signal (even discounted for the smaller circulation offered by cable) would also be expensive in the same circumstances.

In short, the Commission's proposal seeks to solve a program diversity problem that does not exist. While certain anecdotes in the record allege that a handful of program networks would like to lease channels if they could only afford it, surely this does not demonstrate a problem of such a dimension that it justifies subsidizing their access on cable systems and displacing other programmers at least as worthy of distribution. And most importantly, such an approach, as demonstrated below, conflicts with the statute.

II. THE PROPOSED FORMULA IS CONTRARY TO THE LEASED ACCESS PROVISIONS OF SECTION 612

A. The Statute Requires Rates That Provide Operators Full Value for Leasing Channels

Congress in 1992 amended Section 612 to give the Commission authority to "determine the maximum reasonable rate that a cable operator may establish ... for commercial use of designated channel capacity, including the rate charged for the billing of rates to subscribers and for the collection of revenue from subscribers by the cable operator for such use."[19] Congress was concerned that cable operators, in setting terms for leasing, were unfairly denying access to programming that would otherwise warrant carriage but for the cable operator's alleged exercise of market power.[20] But there is no indication that Congress intended that the FCC set rates in

---

[19] 1992 Cable Act, § 9 (b).

[20] See 1992 Senate Report at 30. ("The legislation reported by the Committee is largely designed to remedy market power in the cable industry. In this context, the leased access provision takes on added importance -- in addition to First Amendment concerns. It can act as a safety valve for

order to facilitate channel leasing by programmers that could not survive in the programming marketplace or that were otherwise unattractive to cable subscribers. And, Congress maintained several provisions of Section 612 from the 1984 Act to ensure that the rates established for leasing continued to protect cable operators against potentially adverse consequences.[21]

Most significantly, Section 612 continues to provide that any rate established should be "at least sufficient to assure that such use will not adversely affect the operation, financial condition, or market development of the cable system."[22] Congress affirmed that the goals of leased access must be achieved "in a manner consistent with growth and development of cable systems,"[23] and chose to maintain its presumption that an operator's rates were reasonable.[24]

The legislative history of Section 612 explains that these statutory provisions were intended to provide leased access on terms that reflected commercial -- not subsidized -- rates. Congress stressed that leased access is not intended to "adversely affect the cable operator's economic position";[25] it cautioned that "[i]f not properly implemented, leased access requirements could adversely impact the economic viability of a cable system, thereby hurting

programmers who may be subject to a cable operator's market power and who may be denied access to be given access on unfavorable terms.")

21 Congress did so even in the face of a Commission recommendation to Congress that it eliminate the deference to cable operator ratemaking. See Cable Television Service (Competition and Rate Deregulation Policies), 67 R.R. 2d at 1812.

22 47 U.S.C. § 532 (c) (1) (emphasis supplied).

23 Id., § 532 (a).

24 Id., § 532 (f) ("In any action brought under this section in any Federal district court or before the Commission, there shall be a presumption that the price, terms and conditions for use of channel capacity...are reasonable and in good faith unless shown by clear and convincing evidence to the contrary.")

25 1984 House Report at 50.

the public";[26] and it specifically acknowledged that in establishing price, terms, and conditions, "it is appropriate for a cable operator to look to the nature (but not the specific editorial content) of the service being propos[ed], how it will affect the marketing of the mix of existing services being offered by the cable operator to subscribers, as well as potential market fragmentation that might be created and any resulting impact that might have on subscriber or advertising revenues."[27]

Congress' goal in providing the Commission authority to establish maximum reasonable rates must be read in conjunction with these important protections against adverse economic effects on the operator. Congress did not intend to require operators to subsidize use of their channel capacity in order to facilitate leasing. This stands in stark contrast to other provisions which mandate that operators subsidize use of their system by certain classes of users. For example, Congress expressly distinguished between leased access rates and subsidized uses of public, educational, and governmental channels which it established at the same time in 1984.[28] As the 1984 House Report describes, "the term commercial use is employed to distinguish from public access uses <u>which are generally afforded free to the access user</u>, whereas third party leased access envisioned by this section will result from a commercial arrangement between the cable operator and the programmer with respect to the rates, terms and conditions of the access use."[29] Congress in 1992 also created mandatory carriage for broadcast signals -- and specified

---

[26] <u>Id</u>.

[27] <u>Id</u>. at 51.

[28] 47 U.S.C. § 531.

[29] 1984 House Report at 48 (emphasis supplied).

that cable operators could not charge broadcast signals for such access.[30] Congress clearly intended no such subsidy here.

Against this backdrop of clear legislative intent, the FCC's proposed cost formula is fatally flawed. As described below, the proposed cost methodology ignores all the significant costs of leasing. And the proposal demonstrably results in rates that would subsidize lessees -- it would require operators in many instances to give away capacity to lessees -- just as operators are required to subsidize PEG access users and must carry broadcast stations. These subsidized rates will adversely affect the "operation, financial condition or market development" of cable systems due to the existing constraints on cable channel capacity and the resulting forced bumping of networks currently carried, and the ill will and confusion that forced realignment of channel line-ups will cause. Customers, who never enjoy changes in their line-up, will face yet more changes that a cable operator could not explain as an enhancement of cable service. These adverse impacts of the Commission's proposed formula will harm systems and benefit cable's competitors that are not subject to the leased access requirements, such as DBS. The FCC's proposal on its face negatively affects the "operation, financial condition [and] market development" of cable as a competitive video distributor.

B. The Proposed Formula Ignores the Value of Channel Space

In recognition of congressional intent, the Further Notice repeatedly acknowledges that leased access rates should not subsidize lessees.[31] Nevertheless, on its face, the proposed cost

---

30 47 U.S.C. § 534 (b) (10) ("A cable operator shall not accept or request monetary payment or other valuable consideration in exchange either for carriage of local commercial television stations in fulfillment of the requirements of this section or for the channel positioning rights provided to such stations under this section . ")

31 See, e.g., Further Notice at ¶ 27 (recognizing that "Congress did not intend that "[c]able operators subsidize programmers who seek access to the system through the provision of Section 612" and

formula fails to reflect the true value of access to the cable system and as a result provides an enormous subsidy to leased access users.

The cost formula includes only a limited number of elements: the operating costs of the system (which the Further Notice proposes would be collected from cable subscribers)[32]; and what the Further Notice terms "net opportunity costs." "Net opportunity costs" as described in the Further Notice, however, bear little or no relationship to true opportunity costs. Instead, they are limited to lost advertising revenue, if any, from the channel that is "designated" for bumping from the system in order to make room for the leased access programmer, lost sales commission, and technical costs, minus any license fees saved from the channel that is bumped.[33] There are numerous flaws in this calculation that make the "cost model" completely inappropriate for use as a means of determining the rates operators should be able to charge for leased access use.

Even on its face, the proposed formula contains numerous erroneous assumptions. It assumes that the existing level of local advertising sales on a channel is the true measure of that channel's worth. But there are several reasons why that simple equation is incorrect. First, there are numerous cable services that do not sell advertising that nonetheless may be carried on a tier, such as C-SPAN, Bravo or Disney. They bring value to the system and its subscribers. In

---

expressing belief that "[b]y setting a maximum rate which covers the operator's quantifiable costs associated with leased access and allows the operator to recover a reasonable profit, our proposed cost/market rate formula...would not require operators to subsidize leased access."); id. at ¶ 65 (the new cost-setting model should "encourage the use of the set-aside channels without giving programmers a subsidy"); id. at 68 (expressing Commission's belief that "the proposed cost/market formula represents a pricing scheme that would promote leased access without giving programmers a subsidy").

32 Further Notice at ¶ 77.

33 Id. at ¶¶ 79-84.

addition, some operators -- particularly small system operators in smaller or more rural markets -- do not have advertising insertion equipment. Yet others may have an over-supply of local advertising avails. And for newer networks, their capacity to serve as a vehicle for local advertising sales may not yet be fully realized. The formula takes no account of these circumstances, again on the assumption that lost advertising sales or commissions are the only appropriate measure of the reasonable costs that leasing imposes on operators.

The Further Notice, however, recognizes elsewhere that "[i]f a channel has a negative net opportunity cost, it may be because the cost formula does not include an approximation of the value of subscriber penetration."[34] But this demonstrates precisely the major flaw in the Commission's tentative conclusion to exclude the effects on subscriber revenues in calculating a new lease rate. The cost model fails to account for the largest element of a measure of true "opportunity costs" -- the impact on subscriber revenues caused by replacing desirable cable programming services with programming that subscribers do not want or do not value as highly.[35] The Further Notice recognizes that this is a legitimate element of "opportunity cost". In fact, it acknowledges that, at least in the context of premium services, the assumption cannot

---

34 Further Notice at ¶ 88.

35 Given that the cost model fails to account for the real costs of leasing, it is not surprising to find that the formula leads to rates that are absurd on their face. Operators in many cases would be able to charge lessees nothing for use of their valuable channel capacity. While the Commission's example in Appendix D of its Further Notice assumes that operators will bump premium services in order to insert leased access service (hence resulting in an average lease rate per channel nowhere near to zero), that is unlikely to be the case. Therefore, inclusion of premium channel revenues in the Commission's example of how its formula would work significantly inflates the likely resulting lease rate.

Instead in all likelihood operators would be forced to take off programming carried on a tier. And, in all likelihood, the programming displaced would have lower advertising revenues than the average channel.

be made that "the leased access premium service will attract the same subscribership as the non-leased access programming."[36] But the Further Notice tentatively concludes that "in the tier context, any such subscriber loss is too speculative to measure accurately."[37] As a result, the formula assumes that the leased access programmer is just as valuable to the operator and its customers as the programmer on the system that it is replacing. It further assumes that an operator's ability to pick which programmer to place on its system and in its package has no value.

The attached economic analysis, by Economists Incorporated, demonstrates why these assumptions are entirely invalid.[38] Economists Incorporated concludes: "While the Commission identifies several sources of opportunity costs, the Commission errs in assuming, without any support or analysis, that some of these costs, indeed the most significant costs, are zero. While this assumption simplifies the maximum rate calculation under the Commission's proposed formula, the assumption is unrealistic, as the Commission itself recognizes elsewhere in the Notice. The Commission's proposed formula produces a subsidy to leased commercial access programmers, and imposes costs on cable operators and cable subscribers."[39]

There is no basis for ignoring the effect on an operator's subscribership caused by ceding up to 15 percent of its channel capacity to others who can program those channels as they wish, without regard to the duplicative nature of the program services or the level of subscriber interest

---

36 Id. at ¶ 94.

37 Id. at ¶ 86.

38 Appendix A, "An Analysis of the Federal Communications Commission's Maximum Reasonable Leased Commercial Access Rate," Economists Incorporated (May 15, 1996) ("EI").

39 EI at 3.

in these services relative to those that have been replaced. While difficult to quantify, it cannot be assumed that subscribers will continue to subscribe to the same level of service once a tier is filled with less appealing programming, or will continue to subscribe to cable at all. As EI explains: "Currently, subscribers pay a fee to acquire a specified package of programming. The Commission appears to believe that the same number of subscribers would be willing to pay the same amount for a different package of programming. Actual experience does not support the assumption that there will be the same number of subscribers and that subscribers would be willing to pay the same amount for leased access programs as for the existing programming."[40]

This is particularly true since cable operators compete against a number of multichannel video programmers not subject to leased access obligations. Subscribers that are unhappy with their loss of cable program services can easily turn to DBS, for example, which may offer all the services that the subscriber previously enjoyed on cable -- and more.[41] Not only will this affect customers' perception of the value of cable's tier offering, but it also potentially could adversely affect cable's ability to obtain customers as it expands into other businesses. And there are additional spill-over effects, such as lost advertising revenues and commissions, that would result from lost subscribership that are not captured by the formula.

The diminished value of a tier without existing programming, and the customer confusion and dissatisfaction that stripping tiers of popular services will engender, would also

---

[40] Id. at 12.

[41] See Annual Assessment of the Status of competition in the Market for the Delivery of Video Programming, CS Docket No. 95-61 (rel. Dec. 11, 1995) (noting competitive gains made by alternatives to cable, such as DBS, MMDS, SMATV and LEC entry).

cause loss of customer goodwill.[42] While customers may not abandon cable service altogether, they may no longer be willing to pay the same price for their service package.

Even where existing programmers are not being displaced, adding new leased access services hurts the value of cable service in other intangible ways. For example, adding a new leased service that is undesirable, in place of a new attractive service that subscribers want, may take away an operator's opportunity to increase subscribership. It may also affect operators' potential to sell advertising on the channel that it can no longer program voluntarily. A leased service that competes directly with existing services on the system may also reduce an operator's ability to obtain commissions from other channels remaining on its system.

C. The Cost Model Would Significantly and Adversely Affect Programmers

There are several other costs from the programmers' perspective that the Further Notice's proposed model ignores. For example, the cost formula fails to take into account lost revenues to the programmer who is being bumped and replaced by a lessee. It also fails to recognize the effect of forcing programmers who remain on the system to be associated with what may be undesirable program services from a subscriber's standpoint. To the extent they are placed among leased access services that few people watch, their viewership may also decline, resulting in lost advertising revenues.[43] As EI describes, "carrying a leased access channel on a tier will

---

[42] This loss of goodwill and customer confusion will undoubtedly translate into other more tangible costs at the system level, such as increased traffic for customer service representatives, who are responsible for handling calls from confused and disgruntled subscribers.

[43] In a shopping mall, a toy store situated next to an adult bookshop would be adversely affected by the diminished perception of its worth. So, too, in the cable context, would placement near program networks that viewers may find offensive or undesirable adversely affect other program networks.

affect the number of subscribers to that tier, and hence will impact other cable networks' revenues from license fees and advertising."[44]

D. The Cost Model Fails to Account for the Benefit to Lessees of Being Placed on a Tier

These negative effects on programmers caused by leasing are coupled with numerous significant benefits to lessees that accrue under the proposal -- all of which are subsidized by programmers, operators, and their viewers. Most importantly, the cost model fails to take into account the tremendous benefit that a lessee derives from being placed in a tier of attractive services.[45]

A cable operator seeks to create a desirable package of programming -- evidenced by the percentage of subscribers that choose to have that package in their homes. Programmers that seek to obtain carriage on a tier engage in marketing and promotional activities, at a significant cost, in an attempt to convince subscribers and the cable operator to carry that particular network.[46] In addition, cable programmers compete vigorously for channel placement, in many cases offering operators incentives to be placed on highly penetrated tiers and to be situated on those tiers among attractive program networks. Leased access programmers who wish to gain subscribership could avoid all the costs that gaining such acceptance entails. By gaining placement on a tier, "a lessee is free-riding on the strength of other cable networks on that tier, rather than generating a demand for its product itself."[47] By piggy backing on the goodwill that

---

[44] EI at 15-16.

[45] EI at 15. ("The right to be placed on a tier represents another subsidy to the leased commercial access programmer.")

[46] Id. at 16.

[47] Id. at 15.

other programmers and the operator have created, a lessee receives significant benefits that are not accounted for in the cost-based model from inserting itself into a package that is already highly penetrated into subscribers' homes. The Commission itself has recognized this value by erroneously insisting that programmers be placed on a tier. As we discuss infra, this proposed requirement misreads the statute. But the proposal evidences the Commission's own acceptance of the fact that being placed on a tier has tremendous value. Yet the Commission's formula at the same time fails to ascribe any value to this tier placement.

Finally, unlike the existing HIF formula, the cost methodology could lead to significant migration of certain program networks to leased channels.[48] If channels are underpriced, certain program networks -- like home shopping or premium services -- might find it advantageous to give up their existing carriage under voluntary terms and conditions, and instead might seek to sell their service directly to subscribers. This migration, which was a primary policy concern of the FCC in setting the existing leased access formula, could adversely affect the financial condition of the cable system, with corresponding detrimental effects on customers.[49]

* * *

All these costs -- both tangible and intangible -- clearly must be taken into account in formulating the appropriate lease rates. Congress in Section 612(c)(1) directed that the rate must be at least sufficient to protect a system's "financial condition" and "market development". The proposed cost model, however, turns a blind eye to these effects. Simply put, the fatal flaw of the Commission's cost model is that it ignores the full range of costs imposed by leasing.

---

48 Id. at 15.

49 It is an axiom of administrative law that an agency may not abandon a significant public policy without some articulation as to why it is no longer viewed as important.

In sum, the proposed leased access formula would provide a massive subsidy to leased access programmers. Operators would be able to recoup none of the opportunity costs -- other than lost advertising revenues or sales commissions -- from lessees, and instead would be forced to charge rates that approach zero. This absurd result cannot possibly satisfy Congress' intent in adopting this provision. And by subsidizing lessees, the cost formula will adversely affect operators, programmers, and their customers.

III. THE COMMISSION SHOULD NOT ADOPT A COST MODEL

When all these factors are taken into account, an appropriate cost model will likely yield a rate in excess of today's HIF formula. Nevertheless, developing such a cost model that properly accounts for all the costs of leasing is a difficult, if not impossible, undertaking. And even if it were possible, as the Commission previously recognized, a "cost-of-service option would likely require extensive accounting, recordkeeping, and costing requirements. We find that it is difficult to justify the cost of this approach, particularly when we are not also requiring it for basic tier rate determinations. It is also possible that substantial migration will occur under this approach, with uncertain and possibly harmful effects on the structure of the industry."[50] A cost approach is no more justifiable now than it was when the Commission reached its prior conclusion.

The Commission previously adopted the HIF formula as an alternative to the cost approach. The existing HIF formula acts as a surrogate for these lost opportunity costs by taking a market-based approach that looks to the implicit cost that a program service pays for reaching subscribers as the measure of the channel's value.[51] We continue to believe that use of a

---

[50] 8 FCC Rcd. 5631, 5949 (1993).

[51] Id. at 5950.

surrogate is clearly preferable to use of a complicated cost formula, even if that cost model properly accounted for all the costs, including opportunity costs, that the proposed cost model ignores.

The Further Notice, however, identifies several concerns with the existing HIF formula. First, the Commission "believe[s] that the highest implicit fee formula is likely to overcompensate cable operators...[T]he highest implicit fee appears to allow double recovery of subscriber revenues (or 'double billing') by the operator."[52] The Commission believes that this double recovery arises under the highest implicit fee formula because an operator may "[r]ecover revenues for carrying the programming once from the subscriber (included in the tier charge) and again from the programmer (included in the implicit fee)."[53] As described above, however, there are significant intangible costs that leasing imposes that are not recovered simply by recovering operating costs. As set forth in detail above, taking away an operator's ability to program a channel cannot be assumed to have no effect on its revenues and in fact is likely to adversely affect revenues. No double recovery, therefore, arises under the existing formula.

The flaw in the double recovery theory is clear from an examination of behavior under the existing HIF formula. If the Commission's theory were correct, an operator would have every financial incentive to lease channels even if the rate charged to the lessee were only a penny over what it would gain from subscribers. This is because any marginal revenue that exceeds marginal costs would be a profit maximizing strategy. As Economists Incorporated explains, if there truly were a "double recovery," "[c]able operators should be replacing cable

---

52 Further Notice at ¶ 29.

53 Id.

networks with leased commercial access channels in order to increase their profits. Since that replacement is not occurring, the Commission's calculation of the costs and benefits associated with leased commercial access must overlook some costs. To some extent, these overlooked costs are the very costs that the Commission later claims are too speculative to measure. These costs are the hidden costs of leased access, in particular the impact of leased access on subscribership and subscriber revenues."[54]

Given the lack of widespread leasing, therefore, there are other costs that explain why it is not profitable for an operator to lease channels even under the existing formula. Marginal costs must be exceeding marginal revenue. The true cost of leasing a channel, therefore, is likely higher in most cases than even the existing HIF formula. Again, this is because the programming that is to be placed on the system in lieu of existing or planned programming is not as valuable to operators or subscribers as other voluntary uses of the channel -- and may in fact have no value or a negative value. The double recovery theory assumes that an operator would have the same number of subscribers to its system or its tier regardless of whether it stripped off up to 15 percent of the channels available. As EI explains, "[b]y focusing solely on operating costs the Commission misses the cost imposed on subscribers, and thereby on the cable operator of carrying less desirable programming."[55]

Second, the Commission expresses concern that "because the implicit fee for many, if not most, non-leased channels is by definition less than the highest implicit fee, the operator is accepting less than the highest implicit fee from many non-leased programmers. Charging the

---

[54] EI at 6 (footnote omitted).

[55] Id. at 7.

leased access programmer the highest implicit fee therefore is likely to overcompensate the operator compared to the amount the operator is willing to accept."[56] One way to address this concern would be to base a formula on the average, rather than the lowest, non-leased access programming cost in determining a channel's value.[57]

NCTA recognizes that adjustments to the highest implicit fee could make the economics of the formula more workable for some would-be lessees. Additionally, introducing the concept of rate averaging could significantly encourage operators to negotiate leased access rates below a maximum rate. We propose below a method to address this concern.

A. The Average Channel Rate Plus Markup

For full-time leased access users NCTA proposes that the current surrogate for the value of the cable channel -- the operator's average per channel revenue -- be reduced by the cable operator's average programming rates for all its regulated cable channels. A compensation formula that reduces the per channel revenue by the average programming cost for all channels on the basic and CPS tiers could be a more accurate measure of the value of a tier channel.

Under the existing HIF approach, the Commission assumes that each channel of service is equally valued by subscribers in using the average channel rate as the base from which the lowest license fee payment is subtracted. That assumption may not be correct as a factual matter. Subscribers may value a particular service much more highly than another. But by

---

[56] Further Notice at ¶ 30.

[57] Such an approach has been suggested in the Petition for Reconsideration filed by the Community Broadcasters Association, which we understand to propose to the extent that costs cannot be established, the Commission should rely on an alternative mechanism, such as use of the "arithmetic mean of all the implicit charges made to unaffiliated program suppliers for a given category plus a 5 percent increment." Petition for Reconsideration of the Community Broadcasters Association, MM Docket No. 92-266 (filed June 21, 1993).

averaging subscriber revenues across all channels of regulated service, the existing approach already assumes an average channel value. To correct for the perceived flaw in subtracting from that average figure the <u>lowest</u> license fee paid to the operator, the Commission could adjust its formula to account for the <u>average</u> license fee paid to the operator.[58] In this fashion, the leased access rate would be consistent by comparing averages to averages, and will likely yield a rate more affordable to lessees. The resulting rate could be considered the system's "average channel rate" for leased access.

This reduction should be calculated by averaging programming costs for all channels carried on basic and expanded tiers. An operator would calculate its total programming costs for programming carried on these tiers, and divide that cost by the total number of channels on its basic and CPS tiers. That per channel average programming cost would then be subtracted from the average per channel rate charged to subscribers to determine the average channel rate.

AVERAGE CHANNEL RATE FORMULA

$$\textbf{Leased Access Rate} = \frac{\textbf{Subscriber Revenue for Basic + CPS} - \textbf{Total Programming Cost for Basic + CPS}}{\textbf{Total Number of Basic + CPS Channels}} \times \textbf{Mark-up}$$

In that manner, leased access users would receive the same rate for access to basic and expanded tiers. A formula that separately calculated this reduction for basic and tier programming would produce rates that are not reasonably compensatory. Such a method would result in little or no discount for basic channels and would create far too great a reduction for tier channels -- and such tier rate would no longer be compensatory to the cable operator. For administrative

[58] EI at 16-17.

efficiency, the Commission should allow multiple system operators to establish MSO-wide average programming costs for all basic and CPS tier channels.

In addition, the Commission should allow operators to add a markup to the average channel rate. While the Community Broadcasters Association proposes a five percent markup,[59] that is too low to adequately compensate the operator and provide a fair return. The Commission has allowed operators an 11.25 percent markup in other rate regulation contexts.[60] The same markup is justified here. A markup will compensate operators for certain costs -- such as lost advertising revenues and administrative costs -- that leasing will impose that are not reflected in the average channel rate. It will also correct for undercompensation to operators for channels that are in fact more valuable than the average.[61]

---

59 CBA Petition, supra n.55.

60 For example, operators are allowed an 11.25 percent markup on equipment costs, and are presumptively allowed the same markup in cost of service proceedings. And in its small system cost-of-service proceeding, the FCC gave small systems substantial flexibility in establishing their permitted rate of return, even if that rate exceeded 11.25 percent. See Sixth Report and Order and Eleventh Order on Reconsideration, MM Docket No. 92-266, 93-215 (rel. June 5, 1995) at ¶¶61-62. Where operators voluntarily provide a channel programming, they are allowed a markup of 7.5 percent. 47 C.F.R. § 922(d)(3)(A). A higher markup is justified here, where leasing imposes additional costs that would not be imposed in cases where an operator could program its channel.

61 The maximum leased access rates for premium program services should continue to be calculated under the existing HIF formula. In the premium program category, the highest per-subscriber implicit fee would be multiplied by the number of subscribers that subscribe to the most popular program service. There is no issue of double recovery with respect to the HIF formula for premium services. Any averaging in the premium context, moreover, could lead to an adverse impact on cable operators. As the Commission recognized previously, if per-channel rates are set too low, certain services may find it beneficial to migrate to an "a la carte" leased channel. See generally 8 FCC Rcd. at 5948.

Single channel lessees, in addition, should not be permitted to force their way into subscribers' homes. Instead, lessees should not be carried in a particular home unless a subscriber affirmatively requests such service.